Montreal 1966
June 6
Ottawa October 19

BETWEEN:

THE READER'S DIGEST ASSOCIATION (CANADA) LTD.—SÉLECTION DU READER'S DIGEST (CANADA) LTÉE ... APPELLANT;

AND

THE MINISTER OF NATIONAL REVENUE ..... RESPONDENT.

Income tax—Income Tax Act, R.S.C. 1952, c. 148—Section 12(1) (a), (b)—Legal expense incurred in challenging validity of tax under Part II (since repealed) of the Excise Tax Act—Whether incurred to earn income.

In this case the appellant has been assessed by the Minister a large amount of tax under Part II of the *Excise Tax Act* (since repealed) and thereafter incurred legal expenses of some $46,616.00 in an unsuccessful effort to prove the tax unconstitutional.

The appellant now sought to deduct the legal expenses as having been incurred for the purpose of gaining or producing income from its business.

Its appeal to the Tax Appeal Board was dismissed on the strength of Exchequer Court's judgment in *Arrco Playing Card Co. (Canada) Ltd. v. M.N.R.*

Held, That recent Judgments "might well go so far as to invalidate the erstwhile tenet that 'an expense incurred once and for all and to secure an enduring benefit' necessarily related to some capital outlay".

2. That, distinguishing the instant appeal from the cases cited by the Minister, the legal expenses "were incurred conformably to the excepting provision of Section 12(1)(*a*), to earn or protect the commercial income of the company".

3. That the appeal be allowed.

APPEAL from a decision of the *Tax Appeal Board.*

Ernest E. Saunders for appellant.

A. J. Campbell, Q.C. and *Paul Boivin, Q.C.* for respondent.

DUMOULIN J.:—This is an appeal from the Tax Appeal Board's decision, dated June 8, 1964, in respect of an income tax assessment for 1960 of the Reader's Digest Association (Canada) Ltd.—Sélection du Reader's Digest (Canada) Ltée, a printing and publishing corporation with

its principal place of business and excutive offices at 215 Redfern Avenue, Westmount, P.Q. Said decision dismissed the company's appeal to the Tax Appeal Board.

The pertinent facts out of which arose the instant suit are concisely stated in the Tax Appeal Board's judgment[1]. I now quote from the notes of Mr. W. O. Davis, Q.C.:

By Section 3 of chapter 37 of the Statutes of Canada (4-5 Elizabeth II), the *Excise Tax Act* was amended by the addition of a new Part II, comprising Sections 8 to 11 and given Royal Assent on August 14, 1956, whereby an excise tax of 20 per cent of the value of the advertising material contained in each copy of a special edition of a non-Canadian periodical published in Canada was imposed by the Parliament of Canada. This tax became effective on January 1, 1957. The effect of this tax was to cause the appellant to pay an excise tax of 20% of its total revenue from the sale of every page of advertising appearing in the aforesaid publications, *Reader's Digest* and *Sélection du Reader's Digest*. It was admitted that the major portion of the appellant's business consisted of the publication of the said two magazines, and that its major source of revenue was the sale of space in these magazines to advertisers. The sale of the magazines to the public was only of secondary importance as a source of revenue

As a result of the imposition of the said excise tax at the beginning of 1957, the appellant was called upon to pay an amount of tax somewhat in excess of $35,000 (exactly $35,225 32) for the month of January of that year. The impact of this tax upon the revenues of the appellant was serious. As a consequence, the appellant consulted its solicitors as to the constitutionality of the tax in question. In April of 1957, the appellant instituted an action against the Attorney-General of Canada, which the appellant has set out in Paragraph 17 of its Notice of Appeal to this Board as follows: (now paragraph 19 of the Notice of Appeal before this Court)

> "17. (19). In April, 1957, Appellant acting upon the advice of its said Attorneys, (Messrs O'Brien, Home, Hall & Nolan) instituted legal action before the Superior Court of the Province of Quebec against the Attorney General of Canada (Case No S C M 417505), praying for judgment declaring that the said Part of the *Excise Tax Act* as enacted by Section 3 of Chapter 37 of the Statutes of Canada 1956 and the Regulations made pursuant thereto, are outside the competence and ultra vires of the Parliament of Canada, and unconstitutional and null and void and non-existent; and that it be declared that Appellant's two said magazines 'The Reader's Digest' and 'Sélection du Reader's Digest' are not periodicals as defined by said Part II of the *Excise Tax Act*; and that Appellant is not liable for the payment of the said tax."

This action was initially dismissed in the Superior Court and subsequently by the Court of Appeal. A further appeal to the Supreme Court of Canada was eventually withdrawn, according to information given me at trial by appellant's counsel.

During the year 1960, appellant's above mentioned attorneys submitted accounts in a sum of $46,616.12 for their

[1] 35 Tax A.B.C. 359, at 360-361.

1966

THE READER'S DIGEST ASSOCIATION (CANADA) LTD. v. M.N.R.

Dumoulin J.

professional services in connection with the legal action against the Attorney General of Canada with regard to Part II of the *Excise Tax Act*.

Claiming "the said legal expenses were made and incurred for the purpose of gaining or producing income from appellant's business, and to protect appellant's right to earn revenue from its sales of advertising...", Reader's Digest deducted the amount of $46,616.12 in its income tax return for 1960, "within the meaning of Paragraph (*a*) of Subsection (1) of Section 12 of the *Income Tax Act*", as alleged in paragraph 29 of the Notice of Appeal.

To this the respondent replies, (paragraph 11) "...that the deduction of legal expenses claimed is prohibited by paragraph (*b*) of subsection (1) of Section 12 of the *Income Tax Act* as such expenses were an outlay of capital or payment on account of capital".

The case was argued solely on points of law and these restricted to the solution of one question: whether or not the legal costs incurred for the purposes above were properly deductible. No argument whatsoever was raised against the competence of the Parliament of Canada to impose such a tax, and no attempt made to substantiate a claim that appellant's two magazines "are not periodicals as defined by the said Part II of the *Excise Tax Act*". I may, therefore, take for granted a tacit waiver of these two grounds, noting also a subsequent rescission of this tax.

The apposite legal provisions admittedly are sections 4 and 12(1)(*a*), or alternatively, should the respondent succeed, (1)(*b*) of section 12 of the *Income Tax Act* (1952, R.S.C., c. 148).

Section 4 is as follows:

> 4. Subject to the other provisions of this Part, income for a taxation year from a business or property is the profit therefrom for the year.

Section 12(1)(*a*) and (*b*) reads:

> 12. (1) In computing income, no deduction shall be made in respect of
>
> (*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or business of the taxpayer,
>
> (*b*) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

One fact at least defies contradiction: the appellant's most remunerative yearly source of income consisted of "the revenue (i.e. profit) resulting from sales of advertising space" in the periodical issues of its two magazines, in keeping with the definition of "income" found in section 4. In the same line of thought it would seem hard to deny that a monthly excise levy or tax cut of twenty per cent of such *profit* unavoidably curtailed, in a proportionate ratio, the appellant's *income* for the corresponding taxation year. (Italicized markings not in text.)

Be that as it may, the problem is susceptible of a more formal approach. The actual text of subsection 12(1)(*a*) was written in the Statute Book at the 1948 parliamentary session, and finally substituted, in 1952, for its predecessor, section 6(1)(*a*) of the *Income War Tax Act*, chapter 97, R.S.C. 1927, which provided that:

> 6. (1) In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of
>
> (*a*) disbursements or expenses not *wholly, exclusively and necessarily* laid out or expended for the purpose of earning the income.

Since Parliament may enjoy the presumption of intending to affect, at least, the operative extent of a law, when proceeding to alter its previous wording, the deletion of three stringently restrictive adverbs: *wholly, exclusively and necessarily,* cannot be considered meaningless. As a touchstone of this opinion, one might apprehend a rather pessimistic reaction in financial and economic quarters, had the 1948-52 amendments decreed the former section 6(1)(*a*) in replacement of the present day section 12(1)(*a*). I feel this view is in line with the interpretation applied quite recently (June 28, 1966) by Martland and Hall JJ., in *Premium Iron Ores Limited v. Minister of National Revenue*[1]. Mr. Justice Martland wrote:

> It seems clear that the present wording of para. (*a*), which first appeared in the 1948 *Income Tax Act*, Chapter 52, Statutes of Canada 1948, was intended to broaden the definition of deductible expenses. The *Income War Tax Act* defined "income" as meaning "the annual net profit or gain or gratuity". Under s. 6(1)(*a*), in computing such profit or gain it was only permissible to deduct expenses wholly, exclusively and necessarily expended for the purpose of earning that income. The present *Act* does not contain this definition of "income". It frequently uses the phrase "income for a taxation year", which appears in s. 11(1) dealing with allow-

[1] [1966] S.C.R. 685.

1966

THE READER'S DIGEST ASSOCIATION (CANADA) LTD. v. M.N.R.

Dumoulin J.

able deductions The phrase does not appear in s. 12(1)(*a*) which, as now worded, permits the deduction of any expense made for the purpose of producing income from a property or business.

In his exhaustive review of the law and more so of the leading precedents, Mr. Justice Hall takes a similar view, I quote:

> It cannot be overlooked that Parliament, in enacting s 12(1)(*a*), did not include the words 'not wholly, exclusively and necessarily laid out or expended' which were in s 6 of the *Income War Tax Act* prior to 1948 and which are found almost verbatim in the English counterpart...except for the word "necessarily". Consequently, the English decisions like *Strong v. Woodifield* and all those founded on *Strong v. Woodifield,* based on the wording of the English rule cannot now be invoked as wholly applicable and indistinguishable in the interpretation of s. 12(1)(*a*) Some significance must be given to the difference in wording noted above, and to the change in wording when the *Income Tax Act* was enacted in 1948. The statement by Abbott J in *B.C. Electric Railway Co. Ltd. v. Minister of National Revenue,* (1958) S.C.R. 133 at p. 136:
>
> > The less stringent provisions of the new section should, I think, be borne in mind in considering judicial opinions based upon the former sections
>
> points up the error that may arise from an unquestioned acceptance of such cases as *Smith's Potato Estates* as being completely applicable in Canada after 1948.

Consequently, the Supreme Court of Canada allowed Premium Ores Limited to deduct, as items of expense, amounts of $12,317.36 and $8,514.16 paid for legal expenses during the 1951 and 1952 taxation years, respectively, in the undergoing conditions summarized by the Tax Appeal Board and excerpted by Mr. Justice Martland:

> . . . the appellant learned some years after it had begun to sell ore in substantial quantities that the American revenue authorities had designs on its income on the alleged grounds that it had been earned in the United States of America and that the appellant had a permanent establishment there within the meaning of the Tax Convention and Protocol between Canada and the United States of America, signed on or about 4th March, 1942. The suggestion that tax liability obtained in the latter country was both surprising and startling to the appellant and steps were taken promptly to ascertain its legal position. It was a matter of great importance to the appellant as, if liability were to be established, the income relating to past, present and future years would be in jeopardy and, according to the evidence heard, in the event of the American claim proving successful, immense harm would be done to the appellant, financially. On this account, opinions were sought in Canada and the United States of America and great trouble was gone to and expense incurred in the latter country for the purpose of ascertaining all relevant facts and reaching a position in which the claim could be effectively opposed if it were proceeded with in the appropriate American court.

The case at issue, here, gave rise to a battle of authorities, not a few of which were but applications of valid principles to other circumstances, more particularly those cited on respondent's behalf.

It is unnecessary to dissert at length on the well-known precedent of *Minister of National Revenue v. Dominion Natural Gas Company Ltd.*[1] to reach at once the conclusion that legal expenses resulting from the defence to an action brought against the company, whose franchise rights to supply natural gas in certain sectors of the City of Hamilton were attacked by a rival organisation, should unquestionably be attributed to capital.

The taxpayer, so to say, therein acted to safeguard the very essence of its commercial existence. Chief Justice Duff most aptly formulated as follows this rather self-evident fact. *Vide* p. 24 of the official report:

> It satisfies, I think, the criterion laid down by Lord Cave in *British Insulated v. Atherton*. The expenditure was incurred "once and for all" and it was incurred for the purpose and with the effect of procuring for the company "the advantage of an enduring benefit". The settlement of the issue raised by the proceedings attacking the rights of the respondents with the object of excluding them from carrying on their undertaking within the limits of the City of Hamilton was, I think, an enduring benefit within the sense of Lord Cave's language...
>
> The character of the expenditure is for our present purposes, I think, analogous to that of the expenditure in question in *Moore v. Hare*, where promotion expenses incurred by coalmasters in connection with two parliamentary bills giving authority to construct a line to serve the coalfield were held to be capital expenditures.

I would add the former Mr. Justice Rand's reference to *Minister of National Revenue v. Dominion Natural Gas* in the affair of *Minister of National Revenue v. Goldsmith Smelting & Refining Co.*[2]. None could hope for a more concise analysis of the governing norm than that found in these brief words of the eminent jurist:

> The judgment of this Court in *The Minister v. Dominion Natural Gas* is clearly distinguishable *as having been a case of expenses to preserve a capital asset in a capital aspect.*

(Italics not in text.)

Another oft-quoted instance of legal costs, expended with a view to secure a benefit of a capital nature, is that of *Montreal Light, Heat and Power Consolidated v. Minister of National Revenue*[3], wherein the company sought to

[1] [1941] S.C.R. 19 at 24. [2] [1954] S.C.R. 55 at 57.
[3] [1942] S.C.R. 89 at 94.

1966

THE READER'S DIGEST ASSOCIATION (CANADA) LTD. v. M.N.R.

Dumoulin J.

deduct, as operating items, fees paid to its lawyers in furtherance of a plan to redeem before due date and reduce the annual outgo for interest and exchange charges bonds in an amount of $15,000,000. These debentures were, of course, so much borrowed capital as declared, with the concurrence of Davis and Kerwin JJ., by Duff C.J. who wrote:

> I have no doubt that the sums borrowed by means of the original issue of debentures were capital, as distinguished from income, or that the sums borrowed by the second issue of debentures for the purpose of retiring the earlier issue were also capital.

The latter decisions, consequent upon legal expenses pertaining to benefits of a capital character, were consistently distinguished by the Highest Tribunal in, among others, *Premium Iron Ores Limited v. M.N.R.* (*supra*); *The Minister of National Revenue v. The Kellogg Company of Canada, Limited*[1]; *Evans v. The Minister of National Revenue*[2]; *Minister of National Revenue v. Goldsmith Bros, and v. L. D. Caulk Company* (tried together)[3]; and *Rolland Paper Co. v. Minister of National Revenue*[4].

In *Kellogg Company of Canada, Ltd.* (I am now, as further down *in re: Evans,* excerpting from Mr. Justice Martland's citations in *Premium Iron Ores Ltd.*):

> . . the question in issue was as to the right of the Kellogg Company to claim as an expense, in determining its taxable income under the *Income War Tax Act,* legal fees incurred by it in successfully defending a suit for an injunction against alleged infringement of registered trade marks by using certain words in connection with the sale of its products. These expenses were held to be deductible under s. 6(1)(*a*) of that *Act,* and not to constitute an outlay or payment on account of capital within s. 6 (1)(*b*). *They fell within the general rule that in the ordinary course legal expenses are simply current expenditures and deductible as such.*

(Italics added.)

In *Evans v. The Minister of National Revenue,* the question in issue was as to the right to deduct, under s. 12(1)(*a*) of the *Income Tax Act* legal expenses incurred by the appellant in connection with an application by the trustee of an estate for advice and directions. What the Court had to determine upon the application was the appellant's right to receive the income from a portion of the estate...The appellant sought to deduct...her legal fees which she paid in that year...(for appeals to the Ontario Court of Appeals and to the Supreme Court of Canada).

This right (to receive income from part of the estate) was held not to be a capital asset, and the expense in question did not fall within s. 12(1)(*b*). Such expense was held to be properly incurred within s 12(1)(*a*) for the purpose of gaining an income to which the appellant was entitled.

[1] [1943] S.C.R. 58 at 61.
[2] [1960] S.C.R. 391.
[3] [1954] S.C.R. 55.
[4] [1960] Ex. C.R. 334.

1966

THE READER'S DIGEST ASSOCIATION (CANADA) LTD. v. M.N.R.

Dumoulin J.

Next, Mr. Justice Rand, in the jointly tried cases of *Goldsmith* and *Caulk*, (*supra*), spoke thus:

The question here is whether expenses incurred by the respondent company in defending itself against charges of violating the criminal law by combining with others to prevent or lessen unduly competition in the commercial distribution of dental supplies, are deductible in ascertaining taxable income The agreement or arrangement alleged to have been unlawful purported to regulate day to day practices in the conduct of the respondent's business It formed no part of the permanent establishment of the business; it was a scheme to govern operations rather than to create a capital asset; and the payment to defend the usages under it was a beneficial outlay that helped to produce the income. These expenses included legal fees both for appearing before the Commissioner under the *Combines Investigation Act* and at the trial which resulted in acquittal.

. . .

In the *Rolland Paper case* (quotation from Mr. Justice Hall's notes in *Premium Iron Ores, supra*) the deduction challenged was for legal fees of $5,948 27 paid (by appellant) in the taxation year 1955 as its share of the legal costs of an appeal against the judgment of the Supreme Court of Ontario finding Rolland Paper Company and others guilty of illegal trade practices contrary to s 498(1)(*d*) of the *Criminal Code*. The case resembled *Goldsmith* and *Caulk* but differed in that where the Goldsmith Company and the Caulk Company had been acquitted Rolland Paper Company was convicted. Fournier J. followed the *Goldsmith* and *Caulk* decision, holding that the fact of conviction was not material He allowed the deduction. Notice of Appeal to this Court was given by the Minister. The appeal was not proceeded with, Notice of Discontinuance having been filed.

However, at trial, respondent's learned counsel rested his argument more on the decision of this Court in *Arrco Playing Card Co. v. Minister of National Revenue*,[1] than upon any other authority.

The Arrco Company manufactured playing cards at its Toronto factory and, eventually, began importing lithographed sheets of cards from the United States. On each form 27 cards were lithographed, two forms representing 35 per cent of the cost of a finished deck.

Manufacture of the sheets into complete ready-for-sale decks (stated Mr. Justice Kearney) was carried out in the appellant's plant by processes known as punch pressing sanding, gilting, deck and box wrapping.

. . . the rate of duty applicable was seven cents per deck, whether imported in a complete state of manufacture or in the form of sheets which required the aforesaid finishing processes Moreover the duty of seven cents per deck applied, whether the material was of a quality to constitute a high or a low-priced deck

. . . appellant authorized its attorney to obtain, if possible, a rectification thereof and a reduction in the existing duty of seven cents per unit.

[1] [1957] Ex. C.R. 314 at 315 (bottom line), 316, 323.

1966

THE READER'S DIGEST ASSOCIATION (CANADA) LTD. v. M.N.R.

Dumoulin J.

This task, successfully prosecuted, meant a saving for fiscal year 1950-51 of $29,734 in customs duties, and similar advantages for the duration, presumably perpetual, of the remedial legislation.

From its 1950-51 income, Arrco Playing Card Co. deducted $11,000, representing fees and disbursements paid during that year to its attorney for professional services "in procuring favourable modifications in the Customs Tariff affecting materials imported by the appellant from the United States". The learned trial Judge, after a thorough and most lucid sifting of all facts adduced, concluded that:

> The expenditure under consideration was, in my opinion, made once and for all to secure a benefit or advantage that was expected to be enjoyed over a lengthy though indefinite future period. The purpose which motivated the expenditure was the appellant's desire to pay less customs duties in the future than in the past. The fact that, in the last analysis, an increase in income should accrue to the appellant does not, I consider, affect the validity of the above-mentioned conclusion.

Mr. Justice Kearney consequently found:

> . . . that the expenditure in question should be regarded as constituting a payment on account of capital, the deduction of which is prohibited under s. 12(1)(*b*).

With reference to the factual elements of both cases, I cannot altogether escape the impression, more readily felt than expressed, that they might differ in some material respects. Nonetheless, I shall abstain from the possibly futile endeavour of singling out any such dissimilarity for the ensuing reason. In *Arrco Playing Card*, the decision appears to be predicated mainly upon an expenditure made "once and for all and to secure an enduring benefit", and not solely for the purpose of gaining or producing income limited to any particular taxation year. On the other hand, the Supreme Court of Canada seems to have ruled out, as a guiding criterion, the limitation to a definite or specific taxation period of the excepting clause in s. 12(1)(*a*), provided, needless to say, that all other qualifying requirements of income producing or *income protecting expenses* are present. To that effect, I must revert anew to, and quote from Justice Martland's and Justice Hall's speeches *in re: Premium Iron Ores Limited v. Minister of National Revenue (cf.* pages 4 and 8 of the typewritten text):

Page 4, Martland J.:

> Clearly these expenses (legal fees in the *Kellogg Company* lawsuit) were not made solely for the purpose *of earning income in the year in*

which they were incurred. They did not result in the earning of income at all. But they were made *with a view to protecting the income earning capacity of the company,* since it must be assumed that the loss of the right to the use of the words in connection with its sales would have indirectly resulted in a reduction of its income, *not only in the year in which they were incurred, but also in future years as well.*

(Italics mine throughout.)

By the same, page 4, now commenting on the *Evans* case:

> Here again, the expense was not one which was made solely for the purpose of earning income *in that year.* . . . Such expense was made in order to protect her right to receive income, *not only in 1955, but in each of the years in which income became available for distribution from the estate.*

Hall J., at page 8:

> The limitation, spelled out in s. 12(1)(*a*), *does not,* in referring to "producing income from the property or business of a taxpayer" *limit the words quoted solely to the taxation year in which the deduction is being claimed. It is a clear indication to me that the income thus referred to may be the income of the taxation year under review or of a succeeding year.*

Statements of like precision and directness are wide-sweeping and might well go so far as to invalidate the erstwhile tenet that "an expense incurred once and for all and to secure an enduring benefit" usually related to some capital outlay.

For the reasons above and, may I repeat, because I entertain no doubt that legal expenses of $46,616.12, hereby sought to be deducted from appellant's 1960 income tax, were incurred conformably to the excepting provision of s. 12(1)(*a*), to earn or protect the commercial income of the company, the appeal is allowed, and the record referred to the Minister for rectification in keeping with the instant judgment. The appellant is entitled to recover its costs after taxation.